

INTERNAL REVENUE SERVICE

Number: **INFO 2001-0274**

Release Date: 12/31/2001

UIL: 3121.01-22

October 10, 2001

CONEX 145866-01

The Honorable Mitch McConnell

United States Senate

Washington, D.C. 20510

Attention: Mr. Brytt Deye

Dear Senator McConnell:

This letter is in response to your inquiry (copy enclosed) dated August 14, 2001, on behalf of your constituent, [REDACTED]. [REDACTED] read about a new IRS ruling concerning the taxation of company stock option plans, that he is very much opposed to.

I believe [REDACTED] is referring to Notice 2001-14, 2001-6 I.R.B. 516, published February 5, 2001 (copy enclosed). In that notice, we simply clarify current law about the application of employment taxes to statutory stock options such as incentive stock options [described in section 422(b) of the Internal Revenue Code (Code)] and options granted under an employee stock purchase plan [described in section 423(b) of the Code]. The notice also provides relief to taxpayers regarding the application of these taxes.

FICA Tax

Employment taxes include the Federal Insurance Contributions Act (FICA) tax. FICA tax is made up of social security and medicare taxes on the wages paid to an employee. The Congress enacted the Social Security Act and the FICA to provide for a federal system of old-age, survivors, disability, and hospital insurance. Under this system, the social security tax finances old-age, survivors, and disability insurance. The medicare tax finances hospital insurance. Thus, FICA tax finances social security retirement benefits and medicare coverage that are important in the lives of many taxpayers.

FUTA Tax

Employment taxes also include the Federal Unemployment Tax Act (FUTA) tax. FUTA is an excise tax imposed on an employer that is based on wages paid in employment. This tax provides for federally aided, state administered unemployment compensation programs that are important in the lives of many taxpayers.

How We Calculate FICA and FUTA Tax

The FICA tax and FUTA tax are calculated as a percentage of an employee's wages. For FICA tax and FUTA tax purposes, wages are defined generally as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. The Internal Revenue Code provisions provide no exceptions from wages for remuneration paid in the form of stock; nor are there any provisions that exclude from wages remuneration received that result from the exercise of a statutory stock option. Accordingly, FICA tax and FUTA tax apply to the payment of wages that arise from a statutory stock option when exercised. The wages paid are equal to the difference between the fair market value of the stock received by an employee pursuant to an exercise of an option and the price paid by the employee for the stock.

Income Tax Withholding

Furthermore, employment taxes include income tax withholding on wages paid to an employee. Like for FICA tax and FUTA tax, for income withholding purposes, wages generally mean all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash. For income tax purposes, a statutory stock option is generally not taxable to the employee either when the option is granted or when it is exercised [see Section 421 of the Code]. Depending upon the circumstances, a statutory stock option may result in compensation income subject to income tax withholding when the stock, that is acquired pursuant to the exercise of the option, is sold or disposed of by the employee. Congressional legislative history indicates that a purpose of income tax withholding is to help individuals pay income tax in the year in which the income is earned. Income tax withholding accomplishes this purpose and serves a very valuable role for most taxpayers.

Notice 2001-14

Notice 2001-14 provides generous relief on the application of employment taxes to statutory stock options. It provides that the IRS will not assess FICA tax or FUTA tax on the exercise of a statutory option exercised before January 1, 2003. The notice also provides that the IRS will not treat the disposition of stock acquired by an employee pursuant to the exercise of a statutory option, that occurs prior to January 1, 2003, as subject to income tax withholding.

We are considering all the comments we received under this notice in developing any further guidance on the application of employment taxes to statutory stock options.

I hope this information is helpful. Please call me at (202) 622-6010 or Elliot M. Rogers, [REDACTED]
[REDACTED] at (202) 622-6040, if you have any questions.

Sincerely,

MARY OPPENHEIMER
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(Exempt Organizations/Employment
Tax/Government Entities)
Office of the Division Counsel/
Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures (2)